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No. 09-

IN THE

Supreme Court of the United States

ANTHONY DiPLACIDO,

Petitioner,

v.

COMMODITY FUTURES TRADING COMMISSION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether aggressive trading during the close on the last day of options trading in a futures market constitutes price manipulation in violation of § 6(c) of the Commodity Exchange Act, when there has been no effort to show market power and the finding of price artificiality is made without requiring any analysis of the economic factors underlying the trading.

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OPINIONS BELOW

The summary order of the United States Court of Appeals for the Second Circuit is unreported. The Second Circuit modified, and as modified, affirmed the November 5, 2008 opinion and order ("Opinion") of the Commodity Futures Trading Commission ("CFTC"), which is unreported. *See* Appendices A-B.

STATEMENT OF JURISDICTION

The Second Circuit's judgment was entered on October 16, 2009. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

7 United States Civil Code § 9 (Commodity Exchange Act § 6(c))

> **Exclusion of persons from privilege of "contract markets"; procedure for exclusion; review by court of appeals**
>
> If the Commission has reason to believe that any person (other than a registered entity) is manipulating or attempting to manipulate or has manipulated or attempted to manipulate the market price of any commodity, in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or has willfully made any false or misleading statement of a material fact in any registration application or any report

> filed with the Commission under this chapter, or willfully omitted to state in any such application or report any material fact which is required to be stated therein, or otherwise is violating or has violated any of the provisions of this chapter or of the rules, regulations, or orders of the Commission . . . thereunder, it may serve upon such person a complaint stating its charges in that respect, which complaint shall have attached or shall contain therein a notice of hearing, specifying a day and place not less than three days after the service thereof, requiring such person to show cause why an order should not be made prohibiting him from trading on or subject to the rules of any registered entity, and directing that all registered entities refuse all privileges to such person, until further notice of the Commission, and to show cause why the registration of such person, if registered with the Commission in any capacity, should not be suspended or revoked. . . .

STATEMENT OF THE CASE

The CFTC's regulatory oversight over futures markets, as set forth in the Commodity Exchange Act, includes the prevention of manipulative conduct. Manipulation was left undefined in the statute in order to encompass all forms of improper conduct. The courts and the CFTC have developed a consensus definition pursuant to which manipulation is characterized as the intentional extraction of artificial prices.

Whether particular trading constitutes manipulation has been determined by applying a four-part test which requires (1) the ability to influence prices; (2) the existence of an artificial price; (3) manipulative intent; and (4) causation. This test has never been challenged, but its application has proved difficult in practice. The typical manipulation case, if adjudicated, takes years to resolve, as this one has, with the concomitant huge expenditure of resources. Thus, few manipulation cases are fully adjudicated. Moreover, because each case is very fact-specific the resulting decision does not necessarily offer much guidance to other actors in the market as to what conduct is prohibited.

At the same time, disruptions in the energy markets have increased the pressure on the CFTC to exercise its policing powers to punish and deter manipulative conduct. The new trade practice-based standard advanced by the CFTC, and approved by the Second Circuit, is an apparent attempt to develop a more efficient mechanism for prosecuting manipulation in the future. The new standard punishes aggressive trading in an illiquid market where the trader has paid more than necessary, as determined by trade practice violations. In relying on trade practices, the CFTC has abandoned the market power analysis employed in manipulation cases (with certain exceptions not relevant here) by other circuits and, up until now, the CFTC. It also has created a standard that is likely to have a chilling effect on futures markets because it is unable to distinguish between improper conduct and legitimate economic activity such as hedging.

Review is warranted to resolve the conflict with existing precedent and to ensure that the CFTC's policing of the futures markets does not interfere with legitimate forces of supply and demand that are essential to their proper functioning.

A. Charges Against DiPlacido

DiPlacido is a registered floor broker on the New York Mercantile Exchange ("NYMEX"), a self-regulated organization under the auspices of the CFTC. DiPlacido was the broker through whom William Taylor and Robert Kristufek, traders at Avista, Inc. ("Avista"), placed orders in 1998 that the Commission's Division of Enforcement ("Division"), in a complaint filed in 2001, charged were intended to manipulate the market. The complaint is reproduced in the Joint Appendix filed in the Second Circuit at A-31–49. The essence of the charge was that Avista wanted to move the daily settlement price – the weighted average of all trades during the "close" or last two minutes of trading – of Palo Verde ("PV") and California-Oregon border ("COB") electricity futures contracts either up or down on the last day of options trading (the "Option Expirations Day") on the NYMEX in April, May, July and August 1998. According to the CFTC, Avista made the trades to increase the profitability of positions it held in unidentified over-the counter ("OTC") options whose value at expiration was based on the settlement price of the PV or COB electricity futures contracts on Options Expiration Day. DiPlacido's sole involvement in the purported scheme is alleged to be as the floor broker who executed the trades during the closes with the knowledge that Avista sought to affect the settlement price and that he traded in such a manner as to effect that goal.

The Complaint charged DiPlacido with five counts of manipulating and attempting to manipulate the settlement price of certain electricity futures contracts, four counts arising from a single allegedly noncompetitive trade executed in furtherance of the manipulation scheme, and one count of failing to produce the required trading documents.[1]

B. Proceedings Before the CFTC

Following a hearing on December 2-3, 2003 and January 12-13, 2004, the ALJ rendered his Initial Decision on September 14, 2004. The ALJ found DiPlacido liable for all counts and imposed sanctions including a cease and desist order, a 20-year trading ban, a registration revocation, and a $500,000 civil penalty. After waiting almost four years to decide the appeal,

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[1] Both Kristufek, the Avista energy trader who placed the orders for the trades at issue, and Taylor, an Avista vice president who oversaw the design and implementation of Avista's electricity trading strategy, settled with the CFTC before the hearing. Kristufek agreed to pay a $155,000 civil money penalty and to accept a 24-month trading ban, and Taylor agreed to pay a $155,000 civil money penalty and to accept a 30-month trading ban. *See In re DiPlacido* (C.F.T.C. Nov. 5, 2008) App. B at 13a, n.2. At the same time the complaint against DiPlacido was filed, the CFTC filed and simultaneously settled administrative proceedings against Avista, Thomas Johns, Avista's vice president of trading, and former Avista trader Michael T. Griswold, alleging the same manipulative scheme. Avista agreed to a cease and desist order and a $2.1 million civil money penalty, Griswold agreed to an 18-month trading ban and a $110,000 civil money penalty, and Johns agreed to a 12-month trading ban and a $450,000 civil money penalty. *Id.* at App. B at 13a, n. 3.

the CFTC affirmed the ALJ's findings that DiPlacido manipulated and attempted to manipulate settlement prices on four of the five days charged, vacated the finding as to the fifth day, and affirmed the ALJ's liability findings on the remaining counts. With respect to sanctions, the CFTC affirmed the imposition of a cease and desist order and registration revocation, modified the 20-year ban to prohibit trading "on or subject to the rules of any registered entity," and increased the civil money penalty from $500,000 to $1 million.

As the CFTC acknowledged at the very beginning of its Opinion, this case "presents issues of first impression: the Commission has never considered a manipulation case based on allegedly manipulative trading floor practices." App. B at 13a. Unlike previous manipulation cases, which involved traditional market corners or squeezes or the spreading of false rumors, the CFTC relied on a trade practice-based manipulation theory that it claimed had been articulated in *In re Henner*, 30 Agric. Dec. 1151 (1971), a case brought by a predecessor agency (the Commodity Exchange Authority) under a predecessor statute. The *Henner* theory, as described by the CFTC, is that a trader paying more than he has to for the purpose of causing the closing price to be at a high price is liable for manipulation. App. B at 16a. *Henner* and its purported underlying theory have never been "exhaustively discussed" by the CFTC. App. at 16a, n.6. Nor has the *Henner* theory ever been subjected to appellate review by the courts.[2]

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[2] The novelty of the CFTC's trade practice-based theory also raised the threshold due process issue of whether in 1998, (Cont'd)

In applying its new trade practice-based theory, the CFTC employed the traditional four-part test for manipulation. The CFTC abandoned a market control analysis to determine whether the manipulator has the ability to influence prices, the first prong of the test. Instead, the CFTC found that DiPlacido had the requisite ability to influence the market because of the large orders placed by Avista in the illiquid NYMEX PV and COB electricity futures markets. Turning to the second component of the four-part test – the existence of an artificial price – the CFTC, borrowing from *Henner*, defined an artificial price as one that is the result of uneconomic trading, *i.e.*, paying more than necessary. App. B at 85a-86a. The CFTC found DiPlacido's trading to be uneconomic based on testimony at the hearing that DiPlacido had violated bids and offers.[3] The CFTC further found that violating bids and offers was sufficient to establish manipulative intent and price impact, or causation, the remaining two elements of the four-part test. App. B at 75a, 92a.

(Cont'd)
the time of the trading, DiPlacido had fair warning that his conduct was prohibited. The CFTC found that *Henner* was sufficient to have given DiPlacido notice of the trade practice-based standard it is now advancing. App. B at 94a-98a.

[3] Pursuant to NYMEX regulations, traders are required to take bids and offers in the order of their attractiveness. Thus, a trader buying contracts in the pit must take the lowest offer to sell first, while a trader selling contracts must take the highest bid first. No charges for violating bids and offers were brought against DiPlacido by the NYMEX.

C. The NYMEX Disciplinary Proceeding Against DiPlacido

Prior to the CFTC proceeding, DiPlacido's conduct was the subject of a NYMEX disciplinary proceeding that focused on the July 27 Close and asserted essentially the same charges as those brought by the CFTC. In a complaint dated December 20, 1999, NYMEX's Compliance Department ("Compliance") alleged eight counts arising out of the after-hours 25-lot trade, one count of attempted manipulation, two counts of conduct detrimental to the Exchange, one count of failure to provide records and one count of failure to supervise. A-1082–1089. Following 10 days of hearing from September through November 2000, the NYMEX Adjudication Panel ("Panel") issued its decision on May 1, 2001. The Panel rejected Compliance's argument that DiPlacido's aggressive bidding during the close constituted manipulation. A-92. The Panel held *inter alia* that the ability to influence price requires effective market control and cannot be equated with the mere ability to affect settlement. Because of the absence of any proof that DiPlacido had such control, he was not liable for manipulation. A-91–95. The Panel did find DiPlacido liable on the counts principally charging an after-hours trade and imposed a 2-month trading ban and $150,000 fine, which was reduced to $50,000 on appeal. Following remand, the Panel affirmed its ruling that Compliance had failed to prove manipulative conduct. A-104–107. On appeal, the NYMEX recognized that the tapes upon which the CFTC rested so much of its case were no more than non-actionable boasts of traders to one another and to their customers of how they are "pushing" the price. A-118.

D. The Court of Appeals' Decision

DiPlacido petitioned the Second Circuit for review of the CTFC's Opinion pursuant to 7 U.S.C. § 9. In a summary order filed October 16, 2009, the Second Circuit modified the CFTC decision by remitting the civil money penalty by $320,000 and, as modified, affirmed the decision.[4] The Second Circuit rejected DiPlacido's challenge to the reasonableness of the CFTC's trade practice-based standard and found that the CFTC had "carefully applied all four elements of the traditional test." App. A at 5a-7a. The Second Circuit rejected DiPlacido's argument that the CFTC had erred by eliminating a market-control requirement on the ground that even supposing large traders in illiquid markets possess the ability to influence prices, the other three elements also must be established. *Id.* at 6a. The Second Circuit also rejected DiPlacido's argument that the CFTC's reliance on violating bids and offers, that is, uneconomic trading, to establish manipulative conduct conflated the remaining three elements of the traditional test: the existence of an artificial price, manipulative intent, and causation. The Second Circuit found that there was evidence in the record other than the violation of bids and offers to establish intent and causation. The Second Circuit did not address the efficacy of uneconomic trading as a measure of price artificiality and dismissed without discussion DiPlacido's

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[4] The remittitur is based on the Second Circuit's holding that the CFTC had erred by fining DiPlacido both for the substantive offense of manipulation and for aiding and abetting, where the underlying conduct was the same. App. A at 11a.

contention that the CFTC's trade practice-based theory failed to distinguish between legitimate hedging activity and manipulative conduct. *Id.* at 6a-7a.[5]

REASONS FOR GRANTING THE PETITION

I. REVIEW IS WARRANTED BECAUSE THE TRADE PRACTICE-BASED STANDARD ADOPTED BY THE CFTC AND UPHELD BY THE SECOND CIRCUIT CONFLICTS WITH THE ESTABLISHED STANDARD FOR DETERMINING PRICE MANIPULATION EMPLOYED BY OTHER CIRCUITS AND THE CFTC AND DOES NOT DISTINGUISH BETWEEN LEGITIMATE ECONOMIC ACTIVITY AND IMPROPER MANIPULATIVE CONDUCT

The CEA prohibits manipulation without defining it. The absence of a statutory definition has been attributed to Congress' concern that "clever manipulators would be able to evade any legislated list of proscribed actions or elements of such a claim." *In re Soybean Futures Litigation*, 892 F. Supp. 1025, 1043 (N.D. Ill. 1995). The task of defining manipulation thus has fallen to the CFTC and the courts, who, given

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[5] The Second Circuit also rejected DiPlacido's due process challenge. It agreed with the CFTC that DiPlacido was on notice because the trade practice-based theory had been adopted in *Henner*. The Second Circuit further found in connection with the notice issue that market power was not a requirement for manipulation in all its forms and that DiPlacido's own actions suggested that he had actual notice that his conduct was wrongful. App. A at 2a-5a.

the "dearth" of settled case law, "are still struggling to define the basic elements of the claim and to differentiate between fair means and foul in futures trading." *Id.* This has led to manipulation cases that are characterized by fact-specific, case by case analysis. *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971) (the test of manipulation "must largely be a practical one"); *In re Indiana Farm Bureau Cooperative Assoc., Inc.*, 1982 WL 30249 at *3 (C.F.T.C. Dec. 17, 1982) (the task of defining manipulation "has fallen to case-by-case judicial development").

Notwithstanding the uncertainty, a general understanding of manipulation has emerged as "an intentional exaction of a price determined by forces other than supply and demand." *Frey v. CFTC*, 931 F.2d 1171, 1175 (7th Cir. 1991). Similarly, the Eighth Circuit has defined manipulation as intentional conduct that has "resulted in a price which does not reflect basic forces of supply and demand." *Cargill, Inc. v. Hardin*, 452 F.2d at 1163. To determine whether manipulation has occurred in a particular case, the courts and the CFTC have adopted a practical, four-part test requiring a showing that

(1) the defendant possessed the ability to influence prices;

(2) an artificial price existed;

(3) the defendant specifically intended to cause the artificial price; and

(4) the defendant caused the artificial price.

Frey v. CFTC, 931 F.2d at 1177-78. *See also In re Cox*, 1987 WL 106879 at *3 (C.F.T.C. July 15, 1987).

In policing the markets for price manipulation, the CFTC historically has focused on "corners" and "squeezes." As explained in *In re Soybean Futures Litigation*:

> [A] party is said to "corner" a market when it has a net long position and owns all or substantially all of the deliverable supply of a particular commodity. . . . A "squeeze" is a lesser form of a corner, in which the manipulator has a dominant long position but does not have an actual monopoly of the cash commodity; rather the cash supply is limited due to drought, unexpectedly heavy demand, or other natural or economic forces that are not necessarily within the manipulator's control. . . . In either case, the manipulator is in a position where he could force the shorts to pay artificially high prices as the delivery date approaches in order to settle their accounts.

892 F. Supp. at 1034 (citations omitted).[6] Another common manipulative device is floating false rumors

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[6] The party buying the futures contract, that is, promising to take delivery of a specific amount of the commodity at a future date for the specified price, is the "long." The party selling the futures contract, that is, promising to make delivery, is the "short." *Cargill v. Hardin*, 452 F.2d at 1156-57. For a description of the mechanics of futures trading, see *Leist v. Simplot*, 638 F.2d 283, 286-88 (2d Cir. 1981).

which affect prices. *See Cargill, Inc. v. Hardin*, 452 F.2d at 1163.

This case is the first time that the CFTC has found liability for manipulation based solely on a trade practice, namely, aggressive trading, including a finding of violating bids and offers, during the close of the last day of options trading. Because the CFTC's new interpretation of the CEA's prohibition of manipulation renders the traditional four-part standard inoperable it is arbitrary and capricious and is not entitled to any deference under *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). In affirming the CFTC's application of its new standard, the Second Circuit has placed itself in conflict with prior interpretations of the statute by other circuits and by the CFTC that, with an exception for false rumors not applicable here, have used market power as the measure for assessing whether the defendant has the ability to influence the price. In addition, the Second Circuit has approved a theory that, by relying on the violation of bids and offers to determine price artificiality, fails to distinguish between conduct that is economically beneficial and conduct that distorts prices. The new standard thus interferes with the legitimate market forces of supply and demand that the CFTC is charged with protecting. *See* Andrew N. Kleit, "Index Manipulation, the CFTC, and the Inanity of *DiPlacido*," Working Paper 09-06, February 2009, Reg-Markets Center, AEI Center for Regulatory & Market Studies ("*Kleit*"), available at http://aei-brookings.org/admin/authorpdfs/redirect-safely.php?fname=../pdffiles/php4h.pdf at 12 (CFTC's new test cannot differentiate between disruptive market manipulation and procompetitive hedging).

A. The Reliance on Aggressive Trading as a Surrogate for Market Power Conflicts With Established Precedent and Is Over-Inclusive

The first problem with the new trade practice-based standard flows from the CFTC's elimination of the requirement that the manipulator have some form of market power. In affirming the CFTC, the Second Circuit has taken a position that is contrary to past precedent in which courts have held that defendants must control either the futures market or the deliverable cash supply in order to have the ability to influence commodity prices. *See, e.g., Cargill, Inc. v. Hardin*, 452 F.2d at 1164 (a squeeze can not be successfully executed unless a long has sufficient control of enough futures contracts to force the shorts to come to the long to settle their contracts); *Volkart Bros. Inc. v. Freeman*, 311 F.2d 52, 59 (5th Cir. 1962) (defendant was not guilty of manipulation because it did not effectively control the spot (cash) commodity to convert its dominant long futures position into an illegal corner or squeeze). The CFTC has also expressed a similar view, explaining that without market power the accused lacks the ability to influence prices because "other market participants can bypass his demands and extinguish their obligations elsewhere." *In re Cox*, 1987 WL 106879 at *4. The market power requirement reflects the economic reality that "[t]o create a competitive imbalance . . . it is necessary for the aspiring manipulator to gain economic power that is disproportionate to other traders." P. Johnson & T. Hazen, 3 Commodities Regulation § 5.07 (1989).

The CFTC abandoned a market power analysis and never alleged that DiPlacido had the kind of market control that could force market participants to deal with him.[7] Instead, the CFTC found that DiPlacido had the required ability to influence the market simply because of the large orders placed by Avista in the illiquid NYMEX electricity futures market. App. B at 72a. The CFTC barely mentioned, let alone examined or established Avista's position in the cash-settling OTC options market – the other relevant market for determining DiPlacido's ability to influence prices by controlling the market. But adding up the number of trades, without more, proves too much. Everyone in the market has the ability to affect the market price, and the more illiquid the market the greater the ability of a single trader or even a single trade to do so. The exercise of this ability to "affect" prices is not the same as the ability to illegally "influence" prices. The CFTC itself has held this: "In a thin market the trading activity of any participant is apt to move the price, but this is not necessarily 'manipulation.'" *Lerner v. Geldermann, Inc.*, 1991 WL 83497 at *7 (C.F.T.C. Jan. 9, 1991) (no evidence that rapid increase in potato futures contracts was result of manipulation). Courts have agreed with this conclusion: "Apex correctly argues that it cannot be held liable if futures or wet market prices dropped simply because of its sale of short contracts." *Apex Oil Co. v. DiMauro*, 713 F. Supp. 587, 606 (S.D.N.Y. 1989). So, too has the NYMEX adjudicatory panel in this case. It found

[7] In fact, as witnesses confirmed at the hearing, at all relevant times there were other brokers or traders on the floor, any of whom could have been a counter-party in place of DiPlacido. *See, e.g.*, A-1085–1088.

that even though DiPlacido, acting on Avista's instructions, may have had the ability to affect the settlement price by aggressively trading during the Close, as did anyone trading then, this basic economic reality did not constitute unlawful "influence" over the price. A-92–93.

The CFTC cited *In re Hohenberg*, 1977 WL 13562 at *2 (C.F.T.C. Feb. 18, 1977) for the proposition that proof of manipulation does not always require a dominant or controlling position in the market. App. B at 71a. That may be true. However, the example given in *Hohenberg* is spreading false rumors, a type of manipulation that is distinguishable from the trading activity here. Trading is by itself neutral. Without an analysis of a trader's position in the market to determine how dominant it is, it is impossible to determine whether particular trades are merely "affecting" the price according to the normal forces of supply and demand, as all trades do, or are "influencing" the price to move in accordance with a manipulative scheme. In contrast, misinformation always distorts prices. No market analysis is required – if the information is false it is designed to artificially influence the price.

The Second Circuit also cited *In re Hohenberg* for the proposition that market control, while a feature of corners and squeezes, is not a requisite for manipulation in all its forms. App. A at 4a. However, like the CFTC, the Second Circuit ignored the distinction between accusations of manipulation based on "uneconomic trading" and accusations based on "spreading false rumors." It accepted, without any analysis, the CFTC's position that equated affecting prices through

aggressive trading with the ability to influence price. In so doing, the Second Circuit has made the first part of the traditional test over-inclusive and ultimately ineffective since it covers any large trades in an illiquid market irrespective of what other actors in the market are doing. The Second Circuit conceded as much when it found that even supposing all large traders in illiquid markets possess the ability to influence those markets, the CFTC's rejection of market control is not arbitrary and capricious because the three other elements of the test must still be satisfied. App. A at 6a. The problem with this conclusion is that the trade practice based-theory does not satisfy the remaining three elements either. *See infra* at 23-24. Thus, when viewed in its entirety, as it must be, the new standard advanced by the CFTC is arbitrary and capricious.

The CFTC and the Second Circuit not only overlooked the distinction between manipulation by trading and manipulation by false rumors; they also misconstrued the nature of the trading that was found to be manipulative in *Henner*. The CFTC simply was wrong when it concluded that Henner did not have market power (App. at 71a), a conclusion that the Second Circuit never expressly addressed but apparently accepted. Henner was charged with manipulation of the closing price, not the settlement price, of the November contract for shell egg futures traded on the Chicago Mercantile Exchange based on a single trade at the close of trading in June. During the few seconds at the end of the close when the last trade was made and the manipulation of the closing price occurred, Henner had complete control over the market. He acquired it by "buying up the board," that is,

purchasing all outstanding contracts then being posted for sale (the method of trading used during the close in lieu of "open outcry" in the trading pit). He then bought one additional contract at the daily limit, thereby raising the closing price from 40.25 cents to 41 cents per dozen eggs. *In re Henner*, 30 Agric. Dec. at 1121. Thus, by dominating the market Henner was able to obtain whatever price he chose, up to the daily limit, because other traders had no place else to go. Anyone who wanted to make a trade had to do it with Henner. This is the same competitive imbalance that is present in the classic scenario of using market control to "corner" or "squeeze" the market. *See Cargill v. Hardin*, 452 F.2d at 1162 (in a squeeze the long "so dominates the futures market . . . that he can force the shorts to pay his dictated and artificially high prices in order to settle their contracts"). It is this market domination, albeit temporary, that gave Henner the ability to illegally influence the closing price. DiPlacido never had the same dominance during any of the closes at issue here that Henner did and thus could not force other traders to deal with him.

To be sure, Henner did not have market power in the sense of controlling the cash commodity, one of the hallmarks of a squeeze. But for purposes of measuring the ability to influence price, this is a distinction without a difference. Because a market squeeze can occur naturally, and without unlawful activity, "the market dominance requirement will quite properly insulate the long from liability, as it is not prevented from acting on its own self-interest to obtain the highest price." *Apex Oil Co. v. DiMauro*, 713 F. Supp. at 602. The market dominance requirement performs a similar

function where, as here, the accusation of manipulation focuses on trading during the close. A closing price, and in DiPlacido's case, a settlement price, can rise or fall for a variety of legitimate reasons. The market dominance requirement is needed to insulate traders who are acting in their own self interest to obtain the highest price – perfectly legitimate conduct – as opposed to forcing other market participants to come to them to pay their price. By abandoning the market dominance requirement, the CFTC, with the Second Circuit's approval, has eliminated the screening function of the traditional test and created a new test that is "non-informative." *Kleit* at 9.

B. The Trade Practice-Based Standard Does Not Distinguish Between Manipulation and Legitimate Economic Activity Such as Hedging

The CFTC acknowledged that all traders have the ability to influence prices and conceded that "something more" is required. App. at 73a. The CFTC found that "something more" in the second component of the four-part test: the existence of an artificial price. The problem that the CFTC faced, however, is the lack of an accepted statistical method for showing an artificial price. "[P]rices fluctuate for all types of reasons that are very difficult to separate out in a legal proceeding." *Kleit* at 10. *See also* Jerry W. Markham, "Manipulation of Commodity Futures Prices – The Unprosecutable Crime," 8 Yale J. on Reg. 281, 284 (1991) (noting that because the economic analysis of the true economic price depends on fluctuating conditions, "it is virtually impossible to determine what constitutes an artificial price"). The CFTC in fact rejected the statistical analysis submitted by the Division's own expert. App. B at 84a-85a.

The CFTC sought to avoid this dilemma by defining an artificial price as one that is the result of uneconomic trading, *i.e.*, paying more than necessary. The CFTC borrowed this definition from *Henner*, a nearly 40-year old case decided by the Commodity Exchange Authority, the CFTC's predecessor agency, and never subjected to judicial scrutiny, Just as Henner paid more than necessary for the last trade at the daily limit (after he bought up the board), DiPlacido, according to the CFTC, paid more than necessary by violating bids and offers. App. B at 85a-86a. But the CFTC's use of trade practice violations to measure price artificiality is equally as problematic as the statistical analysis it rejected.

Market participants generally have the right to trade in their own best interests so long as their trading is responsive to legitimate market forces. *In re Indiana Farm Bureau Cooperative Assoc., Inc.*, 1982 WL 30249 at *5. *See also Apex Oil Co. v. DiMauro*, 713 F. Supp. at 602 (a long "is not prevented from acting in its own self-interest to obtain the highest price"). This includes the right to trade aggressively, *i.e.*, to buy high or sell low. Indeed, as explained by DiPlacido's expert, given Avista's position in the over-the-counter options or derivative market, DiPlacido's aggressive trading on Avista's behalf during the Closes on Option Expiration Days reflects a routine hedging strategy to unwind Avista's OTC position. A-712. *See also Kleit* at 14. Assuming that Avista had bought options in the OTC market to hedge its position in the futures market, a strategy that was alluded to during testimony (A-511) but was never established or apparently even investigated by the Division, Avista would still have had one month left of financial exposure on its remaining

futures position until the expiration of those contracts on their delivery date. Therefore, it would have been sound economic strategy to unwind some or all of that remaining position. Moreover, because Avista's profit depended upon the price at which it first sold short to establish the hedge, the settlement price would not have mattered to Avista. The key to executing its strategy was to buy (or sell, as the case may be) a sufficient number of contracts that Avista deemed appropriate to unwind its position. A-1768–69, 1773–74.

The CFTC's theory fails to take into account hedging – one of the purposes of a futures market.[8] Rather, under its theory, aggressive trading becomes manipulation whenever a trader pays more than he would have to pay or sells for less than he could receive, even if there are legitimate economic reasons to do so, such as hedging. The CFTC made that determination based not on Avista's market positions, as to which there was no evidence in the record, but on DiPlacido's misconduct, that is, his violation of bids and offers. No court has ever found artificiality based solely on trader misconduct. *See In re Soybean Futures Litigation*, 892 F. Supp. at 1057-58. Nor is there any reported instance

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[8] "Hedgers" use the futures market as protection from the risk of adverse price fluctuations by fixing the price of a transaction that will not be consummated until a future date. "Speculators," the persons willing to take that risk, invest in commodity futures contracts for capital appreciation, thereby supplying needed risk capital and liquidity. *Cargill v. Hardin*, 452 F.2d at 1158.

until now of the CFTC ever having prosecuted a trader for violating bids and offers.[9]

Although *Henner* found that the trader had paid more than he had to, its finding was not based on trader misconduct. Rather, the judicial officer deciding the case performed a detailed analysis of both the market forces at work when the trader dominated the market when he made the last trade of the day and more traditional measures of price artificiality, including a comparison of point spreads for the November contract in the preceding and subsequent months and an examination of trading in contracts for other months. 30 Agric. Dec. at 1194-1258. Perhaps most importantly, unlike here, the judicial officer examined Henner's position in the cash market. *Id.* at 1221. Moreover, the judicial officer expressly limited the application of his analysis to trading occurring several months away from delivery. *Id.* at 1206. In that situation it is easier to isolate prices that do not reflect the legitimate forces of supply and demand because there are no externalities to factor in such as the impact of Options Expiration Day on trading when, as here, traders are seeking to unwind their position.

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[9] There are several apparent reasons why violating bids and offers has never before been found to be market manipulation. "First, the harm from violating bids is not obvious. Some bids are temporarily overlooked, but those offers still remain on the floor and in a position to affect market prices. Second, other traders can punish the bid violator by refusing to trade with them in future trades. Third, commodity exchanges, which are self-regulatory organizations, can punish violators by themselves." *Kleit* at 10-11. In this connection, it should be noted that the NYMEX chose not to bring any charges against DiPlacido for violating bids and offers.

Under the CFTC's new theory, uneconomic trading not only establishes artificiality but also supports an inference of intent and a showing of causation. App. B at 75a-76a, 87a-93a. It thus collapses these three elements of the four-part test and turns violation of bids and offers into a form of per se manipulation. A trader who violates a bid or offer by definition is paying more (or selling for less) than the trader would otherwise have to do. The trader thus is causing a price that will always be found artificial, and, assuming there is no liability for accidentally violating bids and offers, will always be doing so intentionally. See *Kleit* at 8-12. Thus, if the CFTC's and Second Circuit's test were indeed merely an application of the traditional standard, one would expect there would have been countless manipulation cases based solely on the violation of bids and offers. However, DiPlacido's case is the first ever.

The Second Circuit was "not persuaded" by DiPlacido's argument that the reliance on uneconomic trading conflated price artificiality, intent, and causation. App. A at 7a. But its determination that the CFTC "carefully applied" all four elements of the traditional test is based solely on the cursory finding that the CFTC's conclusion is supported by evidence other than violating bids and offers. App. A at 7a. The Second Circuit overlooks that, having rejected its own expert's statistical analysis, the only way the CFTC could show that DiPlacido had paid more than he had to, that is, had created an artificial price, was to establish that he had violated bids and offers. In the absence of any analysis of market forces, however, it is impossible to tell whether a violation of a bid or offer is procompetitive or not. The Second Circuit had no answer to this

dilemma. It did not even address the CFTC's use of "uneconomic trading" to measure price artificiality. Thus, it ended up approving a test that interferes with the legitimate economic functions of futures markets and cannot be equated with manipulation as that term has been construed by the courts, and up until this case, the CFTC.

CONCLUSION

For all the foregoing reasons, petitioner respectfully requests that the Supreme Court grant review of this matter.

Respectfully submitted,

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